BEFORE THE ARIZONA CORPORATION C

COMMISSIONERS
KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
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BOB STUMP

IN THE MATTER OF THE APPLICATION OF JOHNSON UTILITIES, L.L.C., DBA JOHNSON UTILITIES COMPANY FOR AN INCREASE IN ITS WATER AND WASTEWATER RATES FOR CUSTOMERS WITHIN PINAL COUNTY, ARIZONA.

DOCKET NO. WS-02987A-08-0180

STAFF'S POST-HEARING REPLY BRIEF

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") responds as follows to the closing briefs filed by Johnson Utilities, LLC doing business as Johnson Utilities Company ("Johnson" or the "Company"), the Residential Utility Consumer Office ("RUCO") and Swing First Golf LLC ("SFG"). The purpose of this Reply Brief is not to repeat every point made in Staff's Initial Closing Brief, nor will it attempt to refute every single issue raised by Johnson, RUCO or SFG, instead Staff relies upon its testimony on those issues not specifically addressed in this Reply Brief. The recommendations of Staff and its positions have been outlined in its Closing Brief as well as its testimony. Staff will highlight some of the major points of disagreement with the Company in this brief.

I. RATE BASE ISSUES.

A. Staff's adjustment to remove 7.5% of plant in service for affiliate profits is not overstated and should be adopted.

Staff continues to support an adjustment of $5,017,752 for the water division plant in service and $7,352,364 for the wastewater division plant in service to remove affiliate profit on affiliate-constructed plant.[1] The Company continues to argue that Staff's disallowance is overstated. Staff's disallowance is reasonable and should be adopted.

The Company complains that the adjustment is overstated because Staff "improperly assumed that all plant recorded on the Company's books was constructed by affiliates."[2] In response to a data

[1] Staff's Final Schedule JMM-W-3 and JMM-WW2.
[2] Company Closing Brief at 4; 15.

request, the Company provided Staff with a copy of an external audit of its financial statements conducted by the public accounting firm of Henry & Horne. The audit was conducted with the proposed sale of assets by Johnson to the Town of Florence.[3] Note 3 to the financial statements regarding related parties stated that the affiliate contracts to perform substantially all of the water and sewer system construction for the Company.[4] Further in Staff's review of canceled checks and bank statements submitted by the Company in support of payments made for plant, Staff's review noted payments to a Company affiliate.[5] The bank records did not indicate payments made to any other construction entity other than an affiliate. Staff selected the midpoint (7.5) of the range of 5% to 10% mark up range found in the documentation provided to Staff by the Company.[6]

With respect to the wastewater division, the Company claims that it provided evidence and testimony that affiliate constructed wastewater plant totaled only $45,724,508.[7] However, Staff's audit of the Company's bank records was unable to verify this amount.[8]

As was noted in Staff's closing brief, the Company bears the burden of persuasion and the burden of production.[9] The Company has simply not met its burden. Staff's disallowances should be adopted.

B. <u>The Company bears the burden of supporting its application and the Staff's disallowance of plant for lack of documentation is reasonable and should be adopted</u>.

Staff continues to recommend a disallowance for inadequately supported plant of 10% of plant in service. The Company argues that Staff should have identified and removed each specific item of plant that was unsupported.[10] The Company's argument presupposes that Staff bears the burden of proof. But it is not Staff's burden to support and prove its plant in service; it is the Company's burden.

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[3] Docket No.WS-02987A- 07-0203.
[4] Ex. S-45 at 14.
[5] Ex. S-45 at 11.
[6] Ex. S-45 at 13.
[7] Company Closing Brief at 17.
[8] Ex. S-45 at 12.
[9] Staff's Closing Brief at 14 citing *Turpen v. Oklahoma Corporation Commission,* 769 P.2d 1309 (Okla. 1989).
[10] Company Closing Brief at 6-7.

Staff's conclusion regarding the inadequacy of the Company's documentation is corroborated by a similar conclusion reached in the 2006 audit report prepared by Henry & Horne. As summarized by Staff witness Jeffrey Michlik, the report stated:

> "Because of the inadequacy of accounting records for the years prior to 2006, we were unable to form an opinion regarding the amounts at which utility plant in service and accumulated depreciation are recorded in the accompanying balance sheet at December 31, 2006, (stated at $168,974,434 and $8,930,075 respectively), or the amount of depreciation expense from the year then ended (stated at $1,799,271)."[11]

The Company suggests that the audit is biased because it was commissioned by the Town of Florence in connection with the proposed sale of Johnson.[12] Company witness Brian Tompsett testifies that Henry & Horne had a financial motive to produce a report that would advocate the lowest possible dollar value for plant in service which in turn would produce the lowest purchase price.[13] This characterization is flawed. The audit was conducted by an independent, external public accounting firm, employing certified public accountants. The auditor's report further avows that it was conducted in compliance with generally accepted auditing standards and included examining the Company's supporting documentation, assessing accounting principles used, and evaluating the overall statement presentation, and was conducted for the purpose of formulating an opinion regarding whether the statements were free of material misstatement. Should the testimony of Company witness Thomas Bourassa, who is also a certified public accountant, be disregarded because he has been retained by the Company and may have a financial incentive to produce schedules that maximize the rates that should be charged? Certainly not. Staff would submit that the auditor's report is credible evidence to support its recommendations.

C. Plant that is not serving customers and is not devoted to public uses is not used and useful and should be disallowed.

The Company contends that even though certain plant is not serving customers, it should nevertheless be considered used and useful simply because it was built in response to developers' requests for service.[14] The Company further argues that since it provided evidence that showed that

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[11] Ex. S-45 at 15.
[12] Ex. A-7 at 4.
[13] Ex. A-7 at 6.
[14] Company Closing Brief at 8 (for water plant); at 19 (for wastewater plant).

the water plant and wastewater plant built to service Silverado development was prudent and that Staff provided no evidence to the contrary, that such plant should be included in rate base.[15]

The Court in *Arizona Water* held: [U]nder our constitution the Corporation Commission must find the fair value of the properties devoted to the public use . . . ." *Arizona Water Co.*, 85 Ariz. 203, 335 P.2d 415. The court further stated: "[A] utility is not entitled to a fair return on its investment; it is entitled to a fair return on the fair value of its properties *devoted to the public use* . . . ." *Id.* In *Consolidated Water Utilities, Ltd. v. Arizona Corporation Commission,* 178 Ariz. at 483, 875 P.2d 137 (App. 1993), the court found that where plant is not yet being used for the benefit of ratepayers, the cost of the plant cannot be included in rate base.

The Company by its own admission has plant that is not serving rate payers; such plant is not used and useful and should not be included in rate base. There is nothing that precludes the Company from seeking recovery of such plant once such plant is placed in service.

D. <u>The Company's arguments against the finding of excess capacity are unpersuasive and should be disregarded.</u>

The Company's arguments in opposing Staff's adjustments for excess capacity are unpersuasive. Staff has recommended the exclusion of one of the three wells and a storage tank located in the Company's Anthem at Merrill Ranch System.[16] The Company seems to assert that exclusion of a well for purposes of plant in service somehow makes that water disappear. The Company states, "If the Rancho Sendero Well #1 were removed as excess capacity, this would leave Johnson Utilities with only 900 GPM of combined pumping capacity..."[17] The well is still in existence. The Company's argument is nonsensical; because one well is excluded from rate base, it would be left with only two wells and if something were to happen to the two remaining wells, it would only have one well and would be unable to serve its customers. The well has not gone anywhere; the water is still there. The Anthem at Merrill Ranch System has three wells and will have three wells with the exclusion (from rate base) of one as excess capacity.[18] The same argument

[15] Company Closing Brief at 8; 20.
[16] Ex. S-36.
[17] Company Closing Brief at 10.
[18] Ex. S-36.

applies to the Company's arguments concerning the exclusion of one of the storage tanks. The well and storage tank are still in existence and capable of serving.

The Company argues that it would be inequitable to disallow the storage tank that will continue to be used as part of the water distribution system.[19] However, as Staff witness Scott testified, it is not an uncommon occurrence.[20] What would be inequitable would be to include in rate base, plant that is in excess of what is needed to serve customers. The well and storage tank are not included as plant in service and there is nothing that precludes the Company from seeking recovery in a future rate case.

E. <u>The Company's proposed treatment of unexpended Hook-up fees is contrary to a recent Commission decision</u>.

The Company proposes to remove $6,931,078 of unexpended hook-up fees (i.e. Contributions in aid of construction or "CIAC") from its CIAC balance for the water division and $16,505 from its CIAC balance for the wastewater division. The Commission has recently rejected such treatment in Decision No. 71414.[21] In Decision No. 71414, the Commission rejected the very treatment of unexpended CIAC as being proposed by Johnson. Further, as in the instant case, Staff recommended the discontinuance of H20's hook up fee tariff, and Staff's recommendation was adopted by the Commission.

The Commission has a long-standing policy of excluding advances and contributions from rate base. The Company's arguments continue to be unpersuasive and should be rejected.

F. <u>There should be no adjustments to CIAC where there is a lack of documentation</u>.

Staff accepted the Company's adjustments to CIAC and AIAC associated with the disallowances for excess capacity and plant found not used and useful and for certain items of post test year plant. Staff however, has serious doubts about the legitimacy of certain invoices and thus could not verify plant values. The Company argues that Staff failed to make any necessary adjustments to its CIAC balance because of its disallowance of wastewater plant not adequately

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[19] Company Closing Brief at 12.
[20] TR 1484:6-14.
[21] In the Matter of the Application of H20, Inc., Docket No. W-02234A-07-0557.

supported by documentation and thus the Staff adjustment creates a mismatch in violation of the matching principle in rate-making.[22] Staff's lack of confidence in the Company's records made it difficult to make any corresponding adjustments.

G. Post Test Year Plant (Wastewater).

The Company continues to attempt to shift the burden of proof to Staff to support its application. In its rebuttal testimony, the Company reclassified $2,201,386 plant that it had classified as post test year plant to plant in service. Staff, lacking confidence in the Company's documentation, continued to classify the plant as post test year plant. The Company asserts that it was Staff's burden to further investigate to determine if the plant was actually placed into service in the test year.[23] This is simply not Staff's burden to bear.

Staff determined that the Parks Lift Station was used and useful during the test year. However, the Company did not perform some of the tasks that are performed when installing an upgrade to a lift station, such as retiring plant that was replaced with the upgraded plant.[24] Staff had little confidence in the integrity of some of the Company's records. Staff attempted to verify the underlying affiliate records for the invoices for the work that was performed by the Company's affiliate, Central Pinal. Staff's attempts were rebuffed because the Company contends that Central Pinal was no longer an affiliate.[25] Staff's confidence in the reliability of the Company's invoices is further diminished by the disclosure of the invoice that was created charging Company employee Gary Larsen for water that he neither used nor was he a guarantor for on the SFG account.[26]

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[22] Company Closing Brief at 18-19.
[23] Company Closing Brief at 22.
[24] Ex. S-44 at 5.
[25] Ex S-44 at 6.
[26] See TR 815-816.

II. INCOME STATEMENT ISSUES.

A. The Commission should adopt Staff's recommendation regarding the Central Arizona Groundwater Replenishment District ("CAGRD") Fees.

Staff recommends that the Company recover its CAGRD tax assessment through the use an adjustor mechanism. RUCO is opposed to the pass through of the CAGRD tax assessment.[27] The Company continues to object to the conditions proposed by Staff.[28]

RUCO, in its opposition to Staff's recommendation of an adjustor mechanism for the recovery of the CAGRD assessment, states that Staff has relaxed the standards the Commission has established for implementing adjustor mechanisms.[29] Staff did not, as RUCO argues, relax the standard that the Commission adheres to when deciding the appropriateness of an adjustor mechanisms. Staff notes, that the Commission has approved adjustor mechanism where appropriate to advance important policy concerns that protect the public interest. Water conservation, in particular groundwater, is an important policy concern of the Commission and therefore the adjustor mechanism recommended by Staff in the instant case is appropriate. The Commission, in the exercise of its plenary ratemaking authority can authorize adjustors as a way for utilities to recoup expenses for items that advance the public interest.

Membership in the CAGRD provides the ability of landowners and water providers to demonstrate a 100 year assured water under the state's assured water supply rules ("AWS").[30] As a member of the CAGRD, the landowner or water provider must pay the CAGRD to replenish any groundwater pumped by a member that exceeds the pumping limits imposed by the AWS rules.[31] The CAGRD is an important tool in the state's groundwater conservation efforts.

RUCO argues that one of the criteria for allowing an adjustor mechanism is to mitigate regulatory lag for volatile, very large expense items.[32] But Staff would note that the Commission has approved adjustors for expenses that are not extremely volatile for Demand Side Management

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[27] Ex. R-1 at 16; RUCO Opening Brief at 8.
[28] Company Closing Brief at 29-31.
[29] RUCO Opening Brief at 10.
[30] Exhibit A-24.
[31] Ex. A-24.
[32] RUCO Opening Brief at 10, citing Decision No. 68302 at 44.

("DSM") and the Renewable Energy Standards Tariff ("REST").[33] The Commission determined that the advancement of energy conservation programs and the move to renewable sources of energy were necessary policy considerations to advance the public interest. RUCO has been as supporter of DSM adjustors and REST adjustors. It would be appropriate in the Commission's support of groundwater conservation to adopt the Staff recommendation regarding an adjustor for the Company's CAGRD assessment.

The Company continues to oppose several conditions proposed by Staff.[34] Staff's Condition No. 5, which requires the Company to provide Staff on even numbered years, the new firm rates set by the CAGRD for the next two years. While the new rates are publically available, Staff, lacking confidence in the Company's record keeping abilities, requires this submittal from the Company to confirm that the Company is charging its customers the correct rates.

Staff's Condition No. 7 requires the Company to submit its proposed CAGRD customer charges for the Phoenix and Pinal AMAs for consideration by the Commission, with the Commission-approved amounts becoming effective the following October 1.[35] The Company continues to oppose this requirement, stating that it is unclear as to what is meant by "consideration" and "approval."[36] The submittal recommended by Staff includes not only the invoice for fees, but the Company's withdrawal and use report it sends to the CAGRD and its annual pumping report it sends to Arizona Department of Water Resources ("ADWR"). The Commission review and approval process each year would ensure that the Company is submitting data to ADWR that is consistent with annual reports filed with the Commission, that the Company is not misinterpreting the correct assessment rate, and that the Company is calculating the customer fee correctly.

B. Income Tax.

The Company is seeking recovery of $1,185,679 as income tax expense and continues to argue that it should be allowed to recover income tax expense even though it is organized as a limited

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[33] See In the matter of Arizona Public Service Company, Decision No. 67744; In the matter of UNS Electric, Decision No. 70360.
[34] Company Closing Brief at 30.
[35] Ex S-43 at 2.
[36] Company Closing Brief at 31.

liability company and does not pay income tax. The following exchange between RUCO attorney and Company witness Thomas Bourassa illustrates the position of the Company:

> Q. (Mr. Pozefsky): Would it be fair to say, Mr. Bourassa that the company is asking to recover income tax that the company itself did not pay to the State or to the IRS?
>
> A. (Mr. Bourassa): You are making a technical distinction.
>
> Q. What's the answer?
>
> A. The answer is no. The LLC or the partnership doesn't pay the taxes directly on their returns.[37]

While the Company claims it is a "technical" distinction, the Company is asking for recovery of taxes that it does not pay and admits that it does not pay taxes. Further the Company elected a form of business to take advantage of the benefits of being an LLC, such as the avoidance of double taxation that exists for C-corporations.[38] Johnson elected to organize itself as an LLC, which is a pass through entity for purposes of income tax liability.

Notwithstanding Johnson's status as a tax pass-through entity, the Company also claims that Staff's proposed treatment is somehow unfair, and continues to compare itself to a C-corporation subsidiary of a holding company. The Company argues on brief that its situation is analogous to a subsidiary C-Corp utility of a parent holding company whose tax return is consolidated with the parent.[39] But what the Company fails to acknowledge is that, in that scenario there is usually evidence of the tax rate. There is no such evidence in this case. The Company failed to provide any evidence regarding the tax rates of its members or that its members even paid any taxes. Further, Mr. Bourassa testified that the basis for the Company's request is an agreement between Johnson and its members to reimburse for the tax liability.[40] The ratepayers are not parties to such an agreement.

In support of its position, the Company in its closing brief cites decisions from several jurisdictions which indicate a split; some jurisdictions allow income tax expense for pass-through

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[37] TR 1357.
[38] TR 1350:3-24.
[39] Company Closing Brief at 32.
[40] TR 1352:16-21.

entities and others do not.[41] For example, in *Re Shoreham Telephone Company Inc*, 2004 WL 2791514 (Vt.P.S.B.), the Vermont Public Services Board denied recovery, stating:

> We recognize that Shoreham's owners as individuals, and like many other investors, will pay income tax on earnings and distributions from the Company. Under federal and state tax law, these sources of income are taxed at the owners' personal income tax rate. This is a direct corollary of Shoreham's internal decision to choose a Subchapter S corporate form and enjoy its attendant benefits. These tax obligations are not, however, expenses that Shoreham (as an incorporated entity) itself must pay. In essence they are an additional form of compensation to investors (who also happen to be employees). In some future case Shoreham might (or might not) be able to justify such payments as a form of employee compensation, or as a necessary payment for capital. However, in this case Shoreham claimed compensation for these costs as income taxes, which they are not. Thus, they cannot be included among the Company's recognized costs of service.

Contrast this Vermont decision to one from Wisconsin. In *Re CenturyTel of Midwest-Kendall, Inc*, 2001 WL 1744202 (Wis.P.S.C.), the Wisconsin Public Service Commission allowed recovery. Century Tel-Kendall was an LLC that had previously been a corporation and was now requesting income taxes as part of its revenue requirement. Century Tel-Kendall paid taxes to its ultimate parent, and the parent filed a consolidated return for all of its affiliates and subsidiary. The Wisconsin Public Service Commission found that there was evidence in the record of the corporate tax rate and acknowledged that the operations of Century Tel-Kendall generated taxable income and thus allowed recovery. In the instant case, Johnson is not a subsidiary of a parent who files consolidated returns.

To bolster its argument regarding the allowance of income tax expense the Company cites *ExxonMobil Oil Corp. v. Federal Energy Regulatory Comm'n* 487 F.3d 945, 376 U.S.App.D.C. 259 (D.C. Cir. 2007), as support for the allowance of income tax recovery for pass-through entities. However, its reliance on *ExxonMobil* is misplaced and is distinguishable from the instant case. The decision by FERC to allow recovery of income tax expense did not come easy and FERC's process of developing an allowance policy has a "tortuous history". *Id.* at 948. FERC determined that it would permit an income tax allowance for all entities or individuals owning public utility assets provided that an entity or individual has an actual or potential income tax liability to be paid on that income from those assets. *Id.* at 950. In the instant case, there is no record of tax liability of the members of

[41] Company Closing Brief at 34.

Johnson. The potential for tax liability is negated by the agreement for reimbursement between the Company and its members.

The Commission is the body empowered by the Constitution and by the people to regulate public service corporations.[42] As such, the Commission, in the exercise of its ratemaking authority has the power to disallow the recovery of income tax expense for pass-through entities. The Arizona Court of Appeals, in the *Consolidated Water Utilities v. Ariz. Corp. Comm'n* case made it clear that it is within the discretion of the Commission allow or disallow income tax expense. 178 Ariz. 478, 875 P.2d 137 (1993). There, the Court held that "the decision to allow or disallow . . . tax expense is to be made by the Commission, and not the Courts." *Id.* at 484, 143.

The Commission will have an opportunity to rule on the matter of income tax expense for pass-through entities in the upcoming December 15 and 16, 2009 Open Meeting in the matter of Sunrise Water Company.[43] The Recommended Opinion and Order ("ROO") drafted by Administrative Law Judge Sarah Harping contains a thorough discussion of the treatment of income tax recovery for pass-through entities by the Commission. As noted by Judge Harpring, the Commission has established a long standing policy of denying recovery of income tax expenses and apparently has varied from it only as an exception made under unique circumstances or as an inadvertent error.[44] There is not reason to deviate from the policy set by the Commission for Johnson.

III. ARIZONA DEPARTMENT OF ENVIRONMENTAL QUALITY VIOLATIONS.

Because of the Company's history of violations issued by the Arizona Department of Environmental Quality (ADEQ), RUCO expressed concerns about the public health and safety of the Johnson ratepayers. RUCO has recommended additional Commission regulatory oversight, in addition to the oversight being provided by ADEQ.[45] RUCO is recommending that the Commission order Staff to perform scheduled and unscheduled visits of the Johnson facilities. RUCO also recommends that the Commission order the Company to provide twice a month or not more less than monthly, confirmation that it is in compliance with all rules and regulations of ADEQ and notice of

[42] See Article 15, Section 3 Arizona Constitution.
[43] Docket No. W-02069A-08-0406.
[44] Docket No.W-02069A- 08-0406; ROO at 36.
[45] RUCO Opening Brief at 29.

any new alleged violations as well as reports of any ADEQ contact and any leaks, overflows or any other incidents.[46]

Staff shares the concerns of RUCO and notes that the Commission receives notification from Johnson when spills have occurred. Any additional inspection and reporting requirements would be duplicative of the work performed by ADEQ and would over burden an already burdened Staff. As RUCO notes in its opposition to the adjustor mechanism that Staff is stretched thin and should not be burdened with oversight of an adjustor mechanism, Staff does not have the resources to commit to additional inspections of Johnson's facilities.

IV. RECOMMENDATIONS OF SFG.

While Staff believes that gravamen of SFG's complaints should be addressed and resolved in the pending complaint docket, Staff would offer comment on several of the SFG recommendations. For the most part, SFG recommends a number of actions, most of which are beyond the constitutional and statutory authority of the Commission to implement. For example, SFG recommends that the Commission order the Company to dismiss all pending defamation lawsuits against its customers and pay all of their court costs and legal fees.[47] When asked if the Commission had the authority to order such an action, SFG witness Sonn Rowell stated "I'm not sure if they do or not"[48]. The Commission does not possess the authority to order such an action.

Staff would oppose the remainder of the SFG recommendations, such as the ordering of a refund. SFG asserts that the Company was over earning during the test year.[49] Staff would note that the Company was charging rates authorized by the Commission in Decision No. 60223, and thus Johnson has charged its customers rates that were deemed just and reasonable, until further determination by the Commission. Generally, the rule against retroactive ratemaking prohibits the retroactive adjustment of rates to account for unexpected expenses or revenues. To require Johnson to refund its customers from 2007 forward raises issues of retroactive ratemaking.

[46] RUCO Opening Brief at 29-30.
[47] SFG Closing Brief at 50.
[48] TR 1077:12.
[49] SFG Closing Brief at 48.

V. CONCLUSION.

Staff respectfully requests the Commission to adopt its recommendations in this proceeding.

RESPECTFULLY SUBMITTED this 11th day of December, 2009.

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